

**PUBLIC VERSION**

Received

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Copyright Royalty Board

Before the  
UNITED STATES COPYRIGHT ROYALTY JUDGES  
THE LIBRARY OF CONGRESS  
Washington, D.C.

_____	)	
In re	)	
	)	
DETERMINATION OF ROYALTY	)	Docket No. 14-CRB-0001-WR (2016-2020)
RATES AND TERMS FOR	)	
EPHEMERAL RECORDING AND	)	
DIGITAL PERFORMANCE OF	)	
SOUND RECORDINGS ( <i>WEB IV</i> )	)	
_____	)	

**AMENDED WRITTEN REBUTTAL TESTIMONY OF MICHAEL HERRING**

(On behalf of Pandora Media, Inc.)

**Introduction**

1. My name is Mike Herring. I am the Chief Financial Officer of Pandora Media, Inc. ("Pandora" or "the Company"). I previously provided testimony during the direct phase of this proceeding.

2. I offer this rebuttal testimony to address several issues raised in SoundExchange's written direct statement: (a) SoundExchange's contention, discussed in the testimony of SoundExchange's economist David Blackburn as well as several fact witnesses, that Pandora is artificially limiting advertising inventory and deferring short-term profitability in favor of user growth; (b) the premise that the interactive-service benchmarks on which SoundExchange relies serve as suitable proxies for the statutory license fees to be paid by a non-interactive service like Pandora, especially when viewed against the economic terms of the direct licenses that Pandora has been entering into; (c) SoundExchange's suggestion that recording artists are not being fairly compensated at the royalty rate Pandora currently pays for sound recording performances; and

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(d) SoundExchange's proposed revisions to the terms and definitions that govern statutory licensees.

### "Sell More Ads" Is a Straw Man

3. In an attempt to divert the Judges' attention away from SoundExchange's exorbitant rate proposal, which surely fails the "willing buyer/willing seller" standard, SoundExchange has offered testimony from several witnesses in an attempt to legitimize that rate proposal on the basis of Pandora's supposed ability to pay the extraordinary fees sought. SoundExchange's witnesses – chief among them Dr. Blackburn – argue that Pandora is *purposely* not doing enough to monetize its listener base – mainly by failing to increase the number of ads we stream per hour of listening (what we refer to as our "ad load"). SoundExchange further contends that Pandora is intentionally foregoing short-term revenue and profitability so as not to sacrifice growth of its user base.<sup>1</sup> The transparent thrust of this testimony is: "Pandora, just sell more ads and you will be able to afford to pay what we are asking."

4. As I understand the standard applied in this proceeding, the Judges are to determine the rate to which a willing buyer and willing seller would agree in a workably

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<sup>1</sup> These themes pervade SoundExchange's direct case. For example, SoundExchange's principal economic expert, Daniel Rubinfeld, testifies that "Pandora has recently indicated that it has reached an 'inflection point' in its profitability, having made a policy choice in the past to sacrifice profits in return for growth." Written Direct Testimony of Daniel Rubinfeld ("Rubinfeld WDT") at ¶ 83 n.65; *id.* ¶ 117. See also SX Introductory Memorandum at 14 ("webcasters often forego short-run profitability in favor of user and market share growth"); Written Direct Testimony of David Blackburn ("Blackburn WDT") at ¶ 54 (Pandora has an "expressed strategy of foregoing short-run profits in favor of longer-run growth . . . allowing Pandora to keep revenues even lower . . ."); *id.* ¶¶ 55-58, 63-81 (Discussion of Webcasters' "Incentive to Increase Marketshare" and Pandora's strategy to do so); Written Direct Testimony of Aaron Harrison ("Harrison WDT") ¶ 13 ("webcasting services have been slow to increase advertising inventory because they are currently focusing on growth in number of users and listener hours, rather than monetization and profit"); Written Direct Testimony of Dennis Kooker ("Kooker WDT") at 14; Written Direct Testimony of Simon Wheeler ("Wheeler WDT") ¶ 38 ("I remain skeptical of the immediate ability or desire of many online ad-supported webcasters to generate revenue. . . . It seems to me that many are still trying to attract a critical mass of users by providing to them as much music as they can.").

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competitive market. The Judges are not, as I understand it, tasked with determining the rate any particular party theoretically could pay and remain in business. The rate that Pandora is theoretically *capable* of paying is simply not informative to the Judges of the rates at which Pandora would be a “willing buyer” of statutory sound recording performance rights.

5. SoundExchange’s supposed evidence along these lines is flawed for numerous additional reasons. To start, it ignores the fact that the royalty formula under which Pandora pays SoundExchange includes a per-play as well as a percent-of-revenue prong. Accordingly, even if Pandora did not run a single ad and earned nothing, SoundExchange’s members would still be paid for every play; indeed, under such payment metric, Pandora incurred over [REDACTED] [REDACTED] in statutory royalties in 2014 alone, making us the single largest statutory licensee and accounting for approximately half of SoundExchange’s statutory royalty distributions. Both Pandora and SoundExchange have proposed a continuation of per-play rates as an element of their rate proposals going forward.

6. SoundExchange’s singular focus on Pandora’s current ad loads also fails to capture real-world dynamics, including the fact that the more ads Pandora runs, the less music it performs, meaning reduced per-play royalties. Similarly, to the extent Pandora loses listeners because of increased ad loads, it would mean *both* fewer payable performances *and* less ad revenue, meaning fewer dollars flowing into SoundExchange’s coffers. As detailed below, the cumulative impact of a seemingly innocuous decline in listening hours can result in very significant declines in revenue over time.

7. Even more fundamentally, SoundExchange’s breezy critique of Pandora’s business strategy misapprehends the realities of business economics, particularly in the marketplace in which we operate: the market for lean-back radio style listening. It fails to grasp

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the challenges advertising-supported non-interactive music services face in achieving long-term profitability, as well as the higher *long-term* value such services promise over subscription-based models. I address these considerations in some detail in the succeeding sections, and summarize my key observations below.

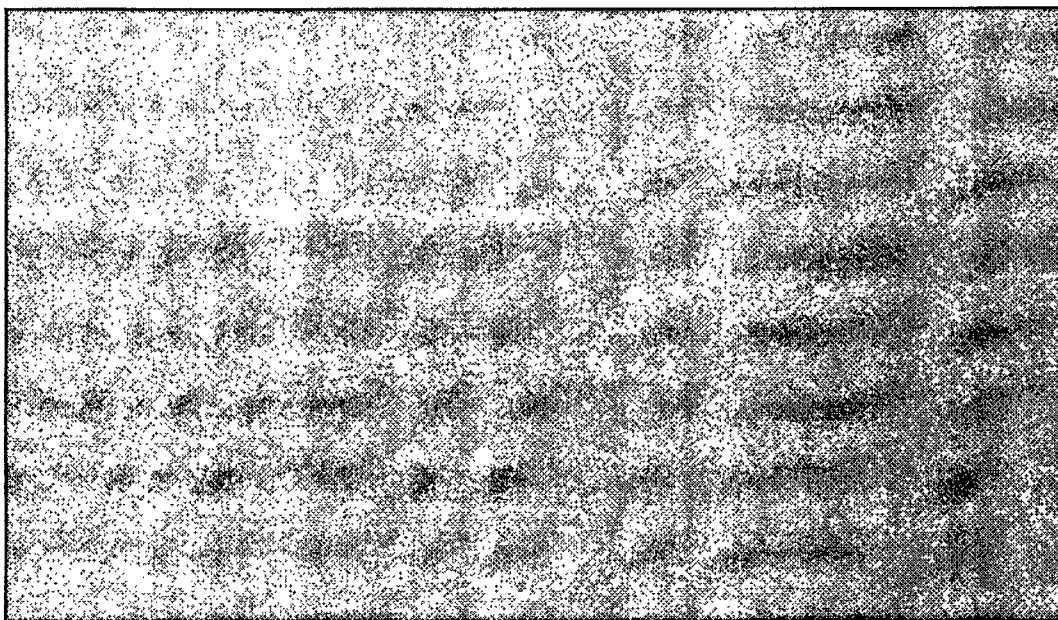
8. First, SoundExchange's myopic focus on short-term profitability ignores the fundamental realities of growing a business like Pandora to scale. Because the business decisions that Pandora makes today affect its profitability in the future, Pandora *is* maximizing profitability, just not necessarily the profitability of the current quarter. Future profits are always a concern for Pandora—like any business—and lower future profits resulting from doing things to increase profits today (*e.g.*, by increasing ad loads too quickly) are “costs” that offset the “value” of today's higher profits. Pandora is keenly focused on revenue growth, and has invested *all* of its revenue *and more*<sup>2</sup> back into its business, investing in engineering, sales, sales support, and other critical components necessary to grow an ad-supported business at scale. As shown in Figure 1 below, Pandora has actually *increased* the monetization of its listeners at the same time it has grown its total listening hours. It seems elementary that such investment in *long-term* profitability stands to serve not only Pandora and its investors, but also the entire record industry, well.

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<sup>2</sup> Pandora had a cumulative net loss of approximately [REDACTED] as of the end of 2014. Combined with its total revenue of nearly [REDACTED], Pandora's total investment is almost [REDACTED] over the life of the Company.

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Figure 1  
[RESTRICTED]



9. Second, by stating or implying that *but for* services such as Pandora, everyone who listens to music would subscribe to a paid service that generates a higher average revenue per user (“ARPU”) grossly mischaracterizes the market for music consumption.<sup>3</sup> There is a clear and meaningful difference between lean-back services such as Pandora and lean-in services such as Spotify. As Figure 2 below shows, the vast majority of music consumers “lean back” when listening to music.<sup>4</sup>

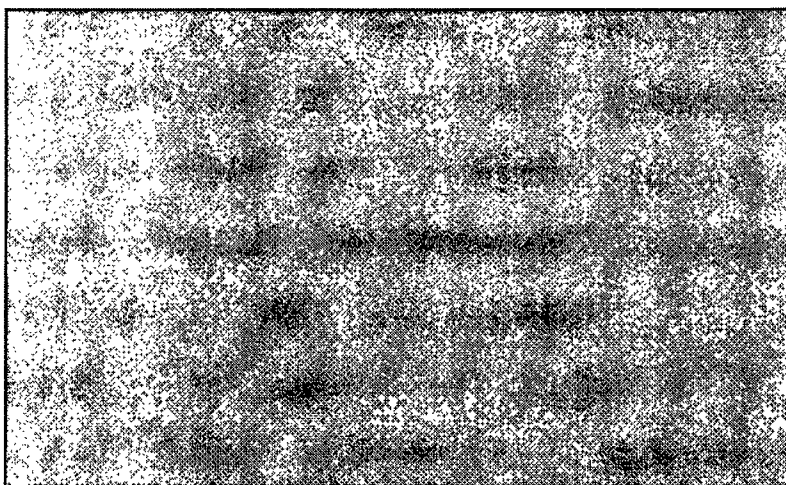
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<sup>3</sup> See Harrison WDT ¶ 16 (suggesting “that Pandora is streaming music to users who might otherwise pay for a subscription or use a higher ARPU streaming service”); see also Kooker WDT at 15, 17; Wilcox WDT at 4-5; Wheeler WDT ¶¶ 30, 35, 38.

<sup>4</sup> Edison “Share of Ear” study, Fall 2014. (“Lean-In” defined as owned music and Spotify, but does not include audio/video lean-in services such as YouTube and Vevo. “Lean-Back” defined as AM/FM radio, Sirius, TV Music Channels, Pandora, iHeart Radio and iTunes Radio.). See also Pandora Exhibit 14 (Interview of Tom Conrad, Pandora’s former Chief Technology Officer, at GigaOM RoadMap 2011) at 1:34-1:43 (“About 80 percent of music consumption, by hours, happens in . . . radio.”) (available at <https://gigaom.com/2011/11/11/pandora-roadmap-2011/>).

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Figure 2  
[RESTRICTED]



10. As Spotify's CEO stated, "I don't really view [Pandora] as a competitor. . . . We don't want to be the radio service. . . We want to be the place where you store and collect, where you build your playlist for your dinner party or your workout. That is very different from Pandora."<sup>5</sup>

11. Consumer research shows that few people who listen to music spend much money on music; the vast majority of the music-consumers view hearing ads as the appropriate "price" to pay to listen to music.<sup>6</sup> According to a leading music consumer research firm, 77% of music

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<sup>5</sup> Georg Szalai, Spotify's Daniel Ek Zings Dr. Dre's Beats Music, *The Hollywood Reporter* (January 22, 2014), available at <http://www.hollywoodreporter.com/news/spotify-daniel-ek-zings-dr-672509>; see also Pandora Exhibit 14 at 10:19-13:40.

<sup>6</sup> See, e.g., MIDiA Research, *U.S. Music Consumer Deep Dive* at 7 (January 2015) ("subscriptions remain fundamentally niche in reach and scale with just 7% penetration. With more than a decade of product offerings the US subscription market is hardly virgin territory. Much of the addressable base for \$9.99 subscriptions has been tapped. The next wave of subscribers will require cheaper tiers. In the meantime Apple's re-launch of Beats Music – whatever name it finally hits upon – will undoubtedly have the most opportunity to expand the market further. Much initial growth however will likely come at the direct expense of the subscription incumbents."); Morgan Stanley, *1st Annual MS Music and Radio Survey* at 2 (January 14, 2015) (finding that 70% of survey respondents indicated little or no willingness to pay for a subscription service). See also Pandora Exhibit 14 at 4:46-5:18 ("Fully half of this country doesn't spend any money on music in a year. Another 40 percent spends about \$14 – 15, something like a single CD a year, and then there is just the 10 percent of people – like you and I – that buy a lot of music. If you want

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listeners spend almost nothing on music.<sup>7</sup> As part of its rebuttal case, Pandora is submitting a new consumer survey the results of which confirm:

- the very small percentage of listeners to lean-back services like Pandora who would consider paying any significant money to subscribe to a lean-in service;
- that if free online music services were no longer available, most consumers would revert to broadcast radio, watch music videos or listen to music on YouTube or Vevo, or simply listen to less music, as opposed to subscribing to a lean-in service; and
- that time spent listening to online, non-interactive services is mostly replacing time spent listening to broadcast radio or is new time that would not have been spent listening to any music at all—almost none of it is taken from listening to lean-in services like Spotify.

While lean-back services such as Pandora may (today) generate a lower ARPU, the size of the lean-back market is so much larger than the lean-in market that, in my opinion, the long-term revenue opportunity for record labels and recording artists is in the lean-back market.

12. The rates Pandora has proposed in this proceeding represent, in my opinion, the best rates for maximizing the long-term revenue of record labels and artists by enabling services such as Pandora to invest in the scale, systems and staff necessary to monetize the Internet radio listener audience. Conversely, the rates SoundExchange proposes would *decrease* the royalties paid by Pandora by diverting revenues needed by Pandora to grow our listenership and advertising revenue (and thereby long-term royalty payments to the record industry) to short-term royalty payments. As I discussed in my direct testimony, if SoundExchange's proposed rates were adopted, Pandora may have to restrict listener hours as we did when we capped mobile listening in 2013, which had the effect of reducing our royalty payments. *See* Written Direct Testimony at ¶ 7.

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to play in that 90 percent opportunity, which is what gets us excited, you have to devise products that have a compelling ad-supported experience.”).

<sup>7</sup> See MIDiA Research, *Music Consumer Segmentation* (December 2014) at 6-7.

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### **I. GROWING AN ADVERTISING SUPPORTED BUSINESS**

13. The elements required to create and maintain an economically successful advertising supported business are straightforward. At a high level, these elements fall into three categories:

- Scale: having a verifiably measurable audience of sufficient size to be of value to advertisers;
- Systems: providing advertisers with efficient, trustworthy mechanisms to plan and transact advertising campaigns; and
- Staff: having the sales and support resources necessary to convince advertisers to entrust their business with you and to reliability execute campaign after campaign.

Putting all of these elements together, however, is extremely difficult, especially in the context of a new type of advertising (such as internet delivered audio advertising) and a new form of ad delivery (such as mobile phones).

#### **A. Scale: Growing a Measurable Audience of Sufficient Size**

14. The first element required for success is attracting an audience of sufficient size. Advertisers generally want to limit their spending to a relatively small number of media properties, each of which contributes meaningfully to the advertiser's goals. Subscale media properties simply are not worth the time and effort of advertisers and their agencies.

##### **1. Growing Audience**

15. A nationwide media property that seeks ultimately to attract both national and local advertising spending will typically seek to grow audience in the following sequence:

##### **a. *National Audience***

16. First is the need to grow a national audience of sufficient scale to be of value to national advertisers. This audience is typically referred to as the National Network Audience. Large, national and international companies such as auto manufacturers (*e.g.*, Ford), big box



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retailers (e.g., Walmart), and consumer packaged goods companies (e.g., Procter and Gamble) that want to reach a wide, national audience with little or no local differentiation are the primary National Network advertisers. National Network advertising is typically sold at relatively low rates because the advertiser is more interested in reach (*i.e.*, brand awareness) than targeting (*i.e.*, activating consumers).

17. In the circumstance in which the platform distributes content to attract audience and pays for that content on a percentage-of-revenue basis, growing a national audience is relatively easy. That is, the additional incremental audience does not necessarily increase the cost of content distributed. In the circumstance in which distributed content is paid for on a per-use basis, however, growing a national audience can be extremely expensive. For example, Pandora paid more than [REDACTED] in sound recording performance royalties before it grew its audience to the point where it ran its first national audio ad campaign, which was for FOX TV's American Idol in January 2009.<sup>8</sup>

### *b. Spot Audience*

18. Second is the need to grow a local audience in each of the top 10 - 20 metropolitan areas of sufficient scale to be of value to advertisers who focus on these top markets. In National Spot advertising, large advertisers seek to target specific (usually large) markets. For example, a home improvement retailer such as the Home Depot might want to advertise snow blowers in Boston, Chicago, Denver, Detroit, Philadelphia, Pittsburgh, New York, Minneapolis-St. Paul, and St. Louis. A variant of this type of advertising is commonly known as Local Spot advertising. Extending the Home Depot example to Local Spot advertising, Home Depot may be interested in advertising snow blowers in Boston, shovels in

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<sup>8</sup> Initially, Pandora was limited to selling display ads, which it could not monetize at levels it has reached with audio advertisements.

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New York and deicers in Chicago. In order to attract National and/or Local Spot advertising, a platform such as Pandora needs an audience equivalent to the number 4 or number 5 terrestrial radio station in that market (approximately 6-8% of the relevant demographic). National and Local Spot advertising is sold at a premium to National Network ads because of the increased audience targeting.

### *c. Local Audience*

19. Third is the need to grow an audience of sufficient scale in more and more local markets to be of value to advertisers who limit their focus to just one of these individual local markets. Here, again, a platform needs at least 6-8% of the targeted demographic in a local market to attract Local ad spend. Local ads are sold at the highest rate because they are the most targeted. National, regional and local advertisers are all competing to reach a targeted demographic in a targeted local market.

20. While Local advertising commands the highest rate, building a local audience large enough to attract those Local ad dollars is the most challenging audience to grow. Other participants in this proceeding have expressed similar challenges in monetizing a local audience.<sup>9</sup>

21. In addition to being the most difficult audience to grow, Local ad sales are also the most “expensive” to grow. National Network and National and Local Spot advertising is often bought directly by the advertiser or by an advertising agency. Advertising agencies may control the advertising budgets of multiple large advertisers. Therefore, a relatively small sales force located in a few markets can be built that targets these large national advertisers and their agencies.

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<sup>9</sup> See Written Direct Testimony of Ben Downs, Vice President and General Manager of Bryan Broadcasting, Inc., at 10 (describing how difficult it is to sell ads in local markets when audience is too small; “In order to even begin to interest advertisers in our streaming audience, we need to increase our listener base significantly.”); *id.* at 11 (explaining that a small local online audience leads to a lack of demand [that] limits the number of ads our stream provider can sell on our streams”).

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22. In contrast, the only way to sell Local ads is by having “feet on the street.” A local sales force is very expensive to build; each local market requires dedicated sales, sales management and sales operations resources. Growing a local sales force means constantly reinvesting the profits of the business into future revenue growth, which is exactly what Pandora has done over the last three years, going from a few local sellers in a handful of markets to [REDACTED] local sellers in [REDACTED] markets. The financial resources Pandora has historically had available to reinvest in growing its local salesforce are severely constrained by the very high royalty obligations it pays to SoundExchange. But for these royalty payments, Pandora could have invested *even more* in developing its local salesforce and could be generating even more revenue than it currently is. By our estimates, if Pandora’s royalty obligations had been only 10% lower, thus allowing us to increase sale-force investment and avoid caps on listening hours, Pandora could have grown total revenue by an additional [REDACTED] and also have generated an additional [REDACTED] in royalties to the record industry.

### 2. Measuring the Audience

23. Advertisers require that the audience they are “buying” is verifiably measurable. For example, when making advertising buying decisions on terrestrial radio platforms, advertisers usually compare stations’ Nielsen Audio (formerly Arbitron) ratings. Nielsen Audio radio ratings measures the size of a station’s audience by collecting data from a random sample of a population throughout the United States, primarily in 294 metropolitan areas, using either its proprietary Portable People Meters (“PPMs”) or a written diary.

24. When Pandora launched in late 2004, there was no equivalent rating service to measure Internet radio audience. This lack of verifiable audience measurement created problems

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not only for Pandora, but as well for terrestrial broadcasters that also simulcast their signal online.<sup>10</sup>

25. The lack of verifiable audience measurement was not a critical issue when Pandora launched because it did not have an audience of sufficient scale to attract even National Network advertising. As Pandora grew, it began measuring its audience using internal server log files. This internal measurement was not sufficiently verifiable to satisfy most advertisers, so in 2010 Pandora engaged Edison Research, a market research firm with a particular emphasis on media research. Edison took Pandora's log files and compiled audience calculations for our top 10 markets. Because Edison was using Pandora's internal log files, this measurement was also not sufficiently verifiable to satisfy most advertisers. In 2011 Pandora approached both Nielsen (then Arbitron) and Triton Digital regarding measuring Pandora's audience in a way that satisfied the standards of the Media Rating Council ("MRC").<sup>11</sup> Triton uses a beacon-based technology to measure Pandora's audience. This technology is similar to Nielsen Audio's PPMs, but Triton's measurement is based on census calculations, while Nielsen Audio's measurement is based on survey panels. In May, 2012, Triton announced an audience rating system for Pandora (and other Internet radio platforms) that extended into local markets. This provided, for the first time, verifiable audience measurement that satisfied advertisers.<sup>12</sup>

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<sup>10</sup> See, e.g., Written Direct Testimony of John Dimick, Senior Vice President of Programming & Operations at Lincoln Financial Media Company, at 7 ("[A] major problem with converting that understanding into advertising dollars has been the *lack of a demonstrated audience* or a consistent ratings boost based on the streaming listenership. While streaming audience measurement remains in its infancy, advertisers have a high comfort level with over-the-air ratings.") (emphasis added); *id.* at 9 ("Advertisers base their buys and the rates they are willing to pay on consistent, demonstrated ratings.")

<sup>11</sup> The Media Ratings Council is an industry-funded organization created at the behest of Congress to review and accredit audience rating services. In addition to setting minimum standards for media rating research, the MRC monitors the activity of rating services through annual external audits of rating service operations performed by a specialized team of independent CPA auditors.

<sup>12</sup> Triton obtained MRC accreditation in March 2014.

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26. Obtaining Triton's MRC-accredited ratings was the critical gating item to Pandora's ad inventory being integrated into media-buying platforms of Mediaocean,<sup>13</sup> Strata,<sup>14</sup> and Telmar,<sup>15</sup> the largest media buying and planning platforms for National Spot and Local Spot radio advertising. As discussed below, integration into these types of media buying systems is part of the infrastructure investment that an ad-supported business must build to be successful at scale.

### **B. Systems: Providing Advertisers with Efficient Mechanisms to Plan and Transact**

27. All major ad spending, both national and local, hinges on a set of systems that (1) enable advertisers to efficiently and reliably plan, execute and measure advertising campaigns and (2) allow platforms to deliver the right audience across all campaigns, especially at scale. Certain systems, such as the independent verified measurement of audience and media buying, require working with third-parties, such as Pandora's integrations with Triton and Mediaocean, Strata, and Telmar.

28. Beyond audience measurement and media buying, other systems must enable the platform to efficiently transact and execute a high volume of advertising campaigns. At the scale of a platform such as Pandora, such transactional activity must be managed automatically (*i.e.*, via computers) lest the volume of transactions consume countless hours of manual administration.

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<sup>13</sup> Mediaocean is an advertising services company that provides advertising purchasing and other services to clients, handling over \$130 billion of advertising spending a year.

<sup>14</sup> Strata Marketing Inc. is a software company that provides a suite of tools for planning buying various forms of media, including TV, cable, radio, print, digital and outdoor, and handles more than \$50 billion worth of media buys annually.

<sup>15</sup> Telmar is a leading supplier of advertising and media information software that allows advertisers and ad agencies to plan and optimize media purchases across digital, print, broadcast and outdoor platforms.

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29. For Pandora today, these systems encompass a wide variety of business functions necessary to produce, schedule and deliver advertising on behalf of national and local advertisers. Getting to this point, however, involved a considerable amount of investment in time and engineering resources. For example, when Pandora began selling ads, it had to invest in ad operations, specifically, ad media servers that could deliver audio and display ads to listeners. As its ad volume increased, Pandora had to invest in order management, specifically the order management software that manages the workflow from the execution of the sale (commonly referred to as an insertion order) to the trafficking of the ad to listeners. Initially, Pandora relied on third-party software. Due to our unique business (*i.e.*, the sale of both display digital and audio advertisements), these third-party systems often required more than ten people across various departments to process a single order. Pandora invested in the development of its own proprietary order management software known as [REDACTED], which has reduced the average order processing time significantly. [REDACTED]

[REDACTED]

[REDACTED]

This greatly increased our order management efficiency, enabling our sales efforts and reducing our operational costs. Pandora continues to invest significant time and resources in adding functionality to [REDACTED] and other advertising technology solutions to drive towards improving the advertising buying experience while also optimizing pricing yield and increasing operational efficiency. For example, [REDACTED]

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30. As its ad volume increased further, Pandora invested in growing its ad trafficking organization. Pandora now employs ☐ people who work on building advertising “creatives”; *e.g.*, the display, audio, and custom advertiser video ads that must be capable of being rendered on a wide variety of desktops, tablets and mobile phones. Pandora’s ad volume, and the creative requirements that flow therefrom, is many magnitudes higher than terrestrial radio. In the first instance, Pandora serves a larger volume of a wider variety of ads (display, audio and video) than any terrestrial radio broadcaster also engaged in webcasting. Because of the wide variety of devices and the multitude of screen sizes commonly used by consumers, Pandora’s creatives must be compatible with a very wide range of formats. In the second instance, Pandora delivers individual ads to individual listeners, in comparison to a terrestrial radio broadcaster, which can deliver a single audio ad to all of its listeners at the same time (that is the definition of “broadcast”). Said differently, to deliver 1,000,000 “impressions,” Pandora has to deliver 1,000,000 ads, while a large terrestrial broadcaster such as Z-100 in New York might only have to deliver 15 or 16 ads and Pandora has to be able to track each “impression” so that it can report back to the advertiser on the success of the campaign.

31. Because personalized Internet radio services such as Pandora deliver individual streams to individual listeners, in addition to higher volume of ads served, Pandora has had to invest in far more complex systems of ad management. That is, just as Pandora delivers personalized music, it also delivers “personalized” ads. Therefore, Pandora has had to build an entire infrastructure that could identify the “right” ad to play to the “right” listener at the “right” time. Because we collect a listener’s age, gender, and zip code at registration, we know these basic demographic facts about our audience. If an advertiser requested, we can, for example, target women aged 25-35 in New York with a particular advertisement. This ability to target

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specific audiences enables us to attract advertising, as well as obtain higher rates for those ads, because advertisers know that their ads are being delivered to those listeners that are most likely to be consumers of their products.

32. To obtain even higher ad rates, Pandora engages in far more sophisticated audience targeting. [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED] Pandora employs [REDACTED] engineers to support this kind of advertising technology.

33. [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

### C. Staff: Selling and Support Resources to Attract and Retain Advertisers

34. Scale and systems are necessary but not sufficient; ultimately, advertisers and their agencies need convincing that their advertising spend on a service like Pandora will be successful. Making this “sell” – accessing the right people and convincing them to try something “new” – requires experienced, talented and trained sales representatives and support staff



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physically present in every place where major decision makers do business. Building a team capable of selling hundreds of millions of dollars of advertising all across the U.S. is a major challenge, requiring years of effort and investment.

35. Moreover, this staffing effort must be carefully coordinated lest it fall out of sync with the scale of the media property's audience or the sophistication of its systems. That is, hiring must keep pace with growing inventory to ensure it is sold, but our sales force cannot grow so fast such that it out-paces inventory and our sellers sit idle. To accomplish all of these objectives, Pandora has hired nearly [REDACTED] people in sales and sales management and another [REDACTED] in sales support roles. Of those new hires, [REDACTED] have been specifically added to our Local sales, sales management and sales support teams.

## II. PANDORA'S EXPERIENCE

### A. Pandora's Audience Growth

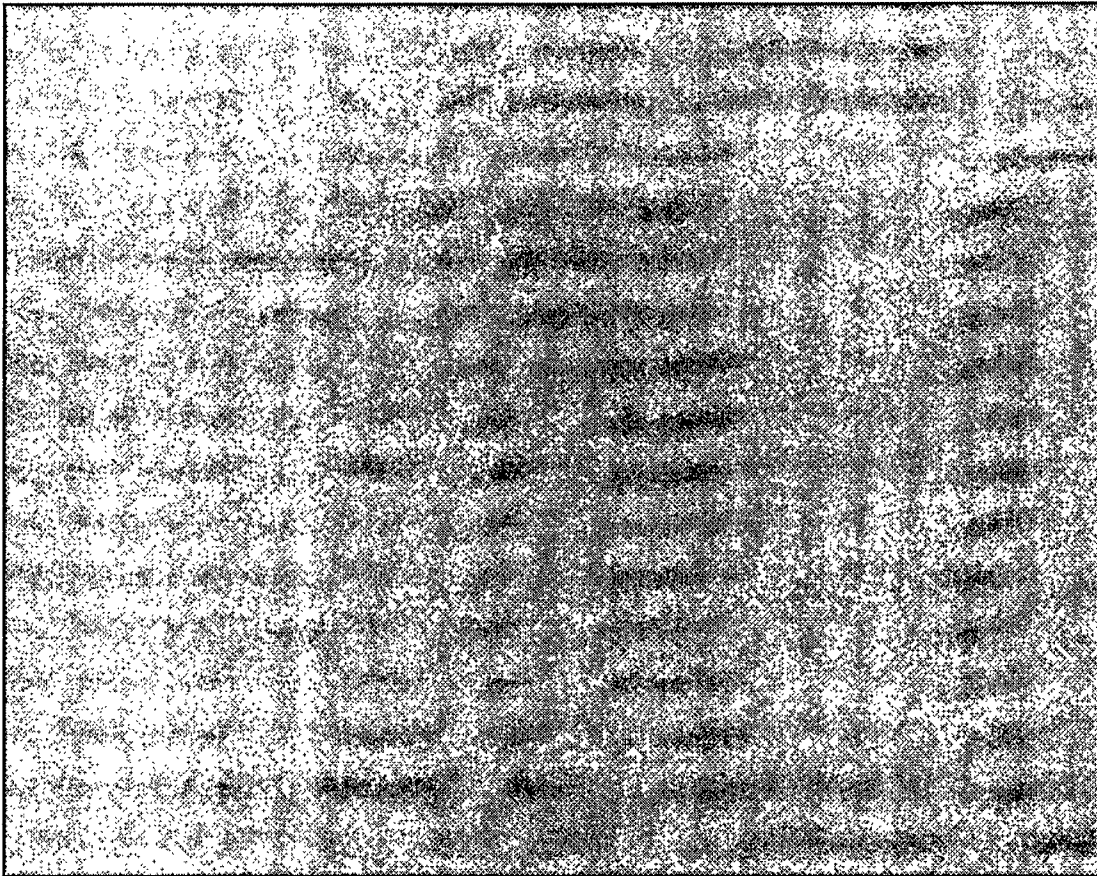
36. In December 2005, after its first full year of operation, [REDACTED] registered accounts logged onto and listened to music on Pandora. In December 2014, [REDACTED] registered accounts logged into and listened to music on Pandora.<sup>16</sup> As Figure 3 demonstrates, based on size of audience, Pandora was the largest radio "station" in all of the top 25 DMAs.

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<sup>16</sup> The total number of listeners is likely higher, since evidence shows that [REDACTED] of our listeners share accounts.

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Figure 3  
[RESTRICTED]



### B. Pandora's Ad-Load Growth

37. Pandora is very serious about revenue growth. In fact, one of our "Principles" is "Revenue is our oxygen." Pandora recognizes that generating revenue is the way we will grow our company, by reinvesting that revenue into software engineers to build a better service, sales reps to sell our ad inventory, and marketing efforts to increase our listenership. Pandora's entire revenue organization, including the Chief Revenue Officer, has, since 2006, been heavily incentivized to generate as much revenue as possible.

38. The key to generating revenue growth is growth in the number of our listening hours. The greater the number of listening hours, the larger the amount of ad inventory we have

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to sell. However, because Pandora pays a per-track, per-listener royalty, growing listener hours means increased content costs. As described in my original written direct statement, on at least two occasions Pandora has capped listening—thereby driving down listener hours—when our growth in listener hours was outstripping our ability to monetize those additional hours.

### 1. Supply Does Not Drive Demand

39. For Pandora, like most ad-supported services, there is a complex interrelationship of factors that must be weighed, balanced and optimized to maximize revenue. Pandora employs █ people in revenue operations (e.g., pricing and yield management) and sales operations (e.g., sales analytics) to undertake this task. In ascertaining how Pandora can sell the highest number of advertisements for the highest price, these employees estimate such effects as (i) the impact increased ad inventory would have on the pricing Pandora could realize for its ads, and (ii) the impact increased ad load would have on overall listener hours. The notion, pressed by SoundExchange, that simply increasing ad inventory would generate increased ad revenue, without taking account of the need carefully to manage both the prices Pandora can obtain for selling advertising and levels of listenership, fails to account for these marketplace realities.

#### a. *Pandora, like all advertising-based services, seeks to optimize its “sell thru” rate*

40. Because supply does not drive demand, an ad-supported service such as Pandora seeks to optimize its sell-thru rate. Where demand closely matches supply, Pandora is able to charge its maximum rate. The flip side, of course, is that demand fluctuates and keeping supply too close to demand risks having unmet demand. Pandora, therefore, tries to keep its sell thru rate for audio ads in the 25 – 54 demographic around █ of inventory.<sup>17</sup> As Pandora achieves

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<sup>17</sup> Pandora is able to “sell” this demographic to advertisers at higher RPMs than it can “sell” the 13 – 24 or 55+ demographics.

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this level, it increases its ad load. In just the last two years, Pandora has increased its ad inventory by more than [REDACTED], while increasing ads sold by [REDACTED]. Because Pandora only increases ad load when it receives the strong market signal that demand does or is about to outstrip supply, Pandora has been able to *increase* ad prices *and* revenue per listener hour, particularly for audio ads, against our primary demographic.

### *b. Pandora Optimizes for the “Lifetime Value” of Each Listener*

41. Another fallacy of the “Simply Sell More Ads” critique is its failure to take account of the need to optimize ad load in a manner that maximizes the revenue generated over the “life” of a listener.<sup>18</sup> We know that serving no ads generates no revenue, and that serving nothing but ads generates no listening (and, therefore, no revenue). The key is to find the right balance point between those extremes that will maximize long-term revenue.

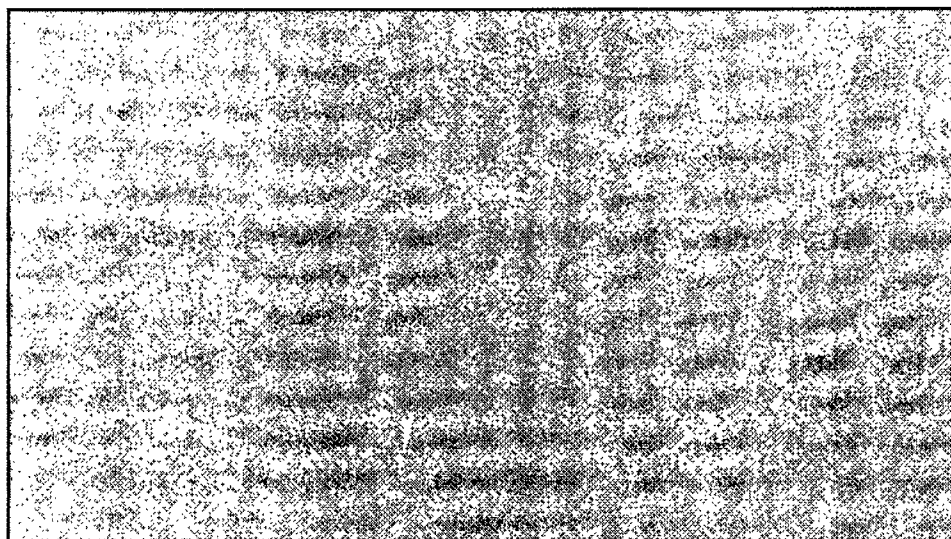
42. The triple goal of ad-supported services is to (1) increase usage, (2) increase ad load, and (3) increase revenue per user. Pandora has been able to achieve all three. To do so, Pandora rigorously studies the impact of additional advertising on listener engagement, including studying listener behavior to determine the impact of various ad loads on listener engagement. In the most recent such study, we were able to determine the impact on listener hours of various levels of ad load. As Figure 4 shows, higher ad load results in reduced listener hours.

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<sup>18</sup> See PAN\_CRB\_00065198 (LTV Model 08.26.2014).

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Figure 4  
[RESTRICTED]



43. A reduction in listener hours reduces our ad inventory, which reduces our ability to generate ad revenue. [REDACTED]

[REDACTED] By empirically studying the effects of ad load, Pandora can maximize long-term revenue generation by optimizing ad load to yield maximum listener hours and utilize targeting and segmentation to yield maximum revenue per advertisement.

### 2. Pandora Invests in Demand Creation

44. Even though supply does not drive demand, Pandora is not without means to stimulate demand. In fact, everything described above are investments Pandora has made in creating demand for advertisements. The [REDACTED] sales people, especially the [REDACTED] Local sellers, are creating demand by knocking on doors and explaining the value to advertisers of advertising on our platform. The [REDACTED] people in Pandora's Sales Marketing group research the market and build collateral to help our sellers most effectively tell that story. The audience measurement by Triton Digital and subsequent integrations with Mediaocean, Strata and Telmar create demand by making advertising on our platform more analogous to purchasing terrestrial radio ads. By

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enabling Pandora to more efficiently deliver and report on the effectiveness of ads run on our platform, Pandora's investment in automation such as Slingshot drive demand.

### 3. More Ads vs. "Better" Ads?

45. A variant of the "simply sell more ads" gloss over reality is, "Pandora, FM stations broadcast more ads per hour than you; why don't you just be more like them?" Pandora's answer is that the approach taken by terrestrial radio stations would *not* maximize revenue in the context of a service like Pandora. First, and perhaps most important, there is substantial data indicating that, while FM stations *broadcast* a higher number of ads, many of those ads are not listened to by consumers. It is critical to understand that in the FM world, consumers can and frequently do change stations when a pod of ads begins on a given station. According to research by Added Value, a global marketing consultancy with over 30 years of experience, 79% of terrestrial radio listeners usually change the station when an advertisement comes on. Thus, there is a very significant difference between the number of ads an individual radio station broadcasts in an hour and the number of ads consumers *actually listen to* in an hour.

46. By contrast, on Pandora consumers cannot skip an ad. Even if they change from one Pandora station to another, the second station will not start playing until the ad is done playing. Thus, talking about the number of ads an individual FM radio station broadcasts in an hour and the number of ads played on Pandora in an hour is an apples-to-oranges comparison. In one case, the consumer actual listens to the ads (Pandora); in the other case they quickly switch to another station (FM radio).

47. The relevant comparison is not how many ads Pandora runs each hour versus FM radio, but how much revenue is generated by each hour of listening. By this metric, Pandora actually monetizes better than FM radio does in three of the largest radio markets, where Pandora has for the longest time had a dedicated local sales force. For example, in San Francisco,

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Pandora's revenue per thousand hours of listening on desktop is [REDACTED], which is higher than average terrestrial radio revenue per thousand hours of listening. Pandora achieves this higher RPM with a lower ad-load for the listener, which drives longer listening, which creates additional ad inventory; *i.e.*, a true virtuous cycle. Over time, we expect that favorable metric to extend to additional markets.

### **Pandora's Direct Licenses Reflect a Superior Benchmark to SoundExchange's On-Demand Benchmark**

48. SoundExchange has built its case around record-company agreements with on-demand services such as Spotify and Rhapsody. Pandora, however, has executed direct license agreements that we believe provide a much better benchmark. First, these agreements cover non-interactive webcasting of the kind covered by the statutory license, meaning, they reflect what Pandora as a willing buyer has demonstrated it is willing to pay to willing sellers for the very rights at issue in this proceeding. Second, the Pandora agreements reflect the workings of competition. Our agreement with Merlin, for example, covering the repertoires of numerous independent record labels, provides for a lower effective per-play rate as we "steer" our plays toward directly-licensed repertory, and thus provides us with a competitive incentive to play directly-licensed tracks more heavily than we would otherwise.

49. As I noted in my direct testimony, the Merlin agreement covers significant and critically-acclaimed sound recordings, including winners of Grammys and other major record-industry awards. At this year's 57th Annual Grammy Awards, artists associated with Merlin labels won the awards in categories for Best Jazz Vocal Album (Concord); Best Jazz Instrumental Album (Concord); Best Bluegrass Album (Concord); Best Folk Album (ATO); Best Gospel Album (eOne); and Dance/Electronic Album of the Year (Warp).

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50. Since signing the Merlin agreement, we have succeeded in increasing directly-licensed spins by approximately [REDACTED]. This means that the effective rate we are paying Merlin on behalf of participating labels is [REDACTED] per ad-supported play. Based on those Merlin labels that have opted in to the agreement, the license covers about [REDACTED] of our total performances.

51. In January, we signed a direct license agreement with Naxos, a leading classical music label. See Pandora Exhibit 15. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

### Pandora's Payments to Artists

52. In October 2012, Pandora posted on its company blog the payments that Pandora would make to certain artists in the coming twelve months (*i.e.*, October 2012 through September 2013).<sup>19</sup> In that post, Pandora stated:

Have you heard of Donnie McClurkin, French Montana or Grupo Bryndis? If you haven't you're not alone. They are artists whose sales ranks on Amazon are 4,752, 17,000 and 183,187, respectively. These are all working artists who live well outside the mainstream – no steady rotation on broadcast radio, no high profile opening slots on major tours, no front page placement in online retail. What they also have in common is a steady income from Pandora. In the next twelve months Pandora is on track to pay performance fees of \$100,228, \$138,567 and \$114,192, respectively, for the music we play to their large and fast-growing audiences on Pandora.

And that's just the tip of the iceberg. For over two thousand artists Pandora will pay over \$10,000 dollars each over the next 12 months (including one of my favorites, the late jazz pianist Oscar Peterson), and for more than 800 we'll pay over \$50,000, more than the income of the average American household. For top

<sup>19</sup> Pandora and Artist Payments, The Pandora Blog (October 9, 2012), <http://blog.pandora.com/2012/10/09/pandora-and-artist-payments/>.



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earners like Coldplay, Adele, Wiz Khalifa, Jason Aldean and others Pandora is already paying over \$1 million each. Drake and Lil Wayne are fast approaching a \$3 million annual rate each.

53. In response to testimony from SoundExchange witnesses Fletcher Foster (Iconic), Raymond Hair (AFM), and Michael Huppe (SoundExchange), individually and collectively seeking to convey the impression that without “strong” (*i.e.*, significantly higher) statutory rates than the rates under which Pandora is now operating, recording artists will be deprived of “fair compensation,” I want to update the above referenced numbers. In 2014, Pandora paid [REDACTED] or more to more than [REDACTED] recording artists and their respective labels. In fact, Pandora paid the equivalent of the median U.S. household income of \$52,000 to more than [REDACTED] artists and their labels. Pandora paid [REDACTED] or more to nearly [REDACTED] artists and their labels. And what about Donnie McClurkin, French Montana, and Grupo Bryndis? Pandora paid them (and their labels) about [REDACTED], [REDACTED] and [REDACTED], respectively, increases of [REDACTED], [REDACTED] and [REDACTED] since the October 2012 blog post. In short, sweeping and unsupported generalizations as to allegedly systematic under-compensation of artists under Pandora’s prevailing rate structure are wholly unfounded. Pandora’s more than [REDACTED] in annual royalties overall and its indisputably generous payments to the most productive artists and labels utterly belies such a notion.

### **SoundExchange’s Proposed Amendments To The Terms Should Be Rejected**

54. In this portion of my rebuttal testimony, I respond to SoundExchange’s proposed Rates and Terms for the 2016-2020 rate period, including, but not limited to, proposed modifications to Sections 380.2, 380.3, 380.4, and 380.6 of the Copyright Royalty Board’s regulations, 37 C.F.R. §§ 380.2, 380.3, 380.4 & 380.6.

#### **A. SoundExchange’s Proposed Definition of Revenue Should Be Rejected**

55. As part of SoundExchange’s rate proposal, which includes a percent-of-revenue prong, SoundExchange has proposed a new definition of “Gross Revenue.” The governing

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webcasting regulations, which to date have been based on a per-play royalty rate, have not previously contained such a definition of revenue. The new Gross Revenue definition that SoundExchange proposes here, however, is very different from the revenue definitions adopted by the Judges in the past for other types of services that do pay based on a percentage of their revenue, including satellite radio (37 C.F.R. § 382.11), preexisting subscription services (Music Choice) (37 C.F.R. § 382.2) and cable/satellite music services (37 C.F.R. § 383.2).

56. Notably, SoundExchange's proposed revenue definition here includes certain unrelated sources of revenue that the Judges have typically and rightly *excluded* – often over the objection of SoundExchange – in the regulations applicable to the other licensee categories:

a) **Product and Sales:** SoundExchange's revenue definition would require Pandora and other licensees to include revenue from “sales of products and services offered as part of or through the Service, including revenue from products and services that are Bundled with the Service.”<sup>20</sup> SoundExchange's revenue definition also includes “Revenue from any software or other product associated with the Service,” including “placement fees for such software or other product.” Assuming Pandora is the licensed “Service” under this definition (we “make eligible transmissions”), this broad definition could be read to sweep in all manner of equipment sales, media player software and other “app” sales, and, most notably, advertising or subscription revenue paid for other non-statutory services offered by Pandora. For that matter, it could include Pandora t-shirts and coffee mugs, if those items were sold “through” or “associated with” the Service.<sup>21</sup>

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<sup>20</sup> “Service” is not limited to transmissions covered by the statutory license, but rather is more broadly defined as a service that “makes eligible transmissions,” even if such transmissions comprise only part of the service offering. “Bundled” is defined as a situation where the user must take/use/receive both the Service and some other product/service.

<sup>21</sup> The only exception allowed by SoundExchange is for products where the Service is Bundled with other products or services “that do not involve the Service.” This exception will have limited effect in shielding

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By contrast, such unrelated revenues are explicitly *excluded* from the definition of “Gross Revenues” for satellite radio. See, for example, 37 C.F.R. § 382.11 at (3)(i) (excluding revenue from sale and/or license of equipment and/or other technology, including bandwidth and receiving devices); (3)(ii) (excluding revenue from intellectual property licenses); (3)(vi)(B) (excluding revenue for “products and/or other services offered for a separate charge where such channels use only incidental performances of sound recordings”); and 3(vi)(D) (excluding revenue from “products and/or other services for which the performance of sound recordings and/or the making of Ephemeral Recordings is exempt from any license requirement or is separately licensed”).

b) **Advertising Agency Commissions:** SoundExchange’s proposed revenue definition includes advertising revenue, as is common, but does not allow for the deductions of ad agency commissions paid by the licensee (which deduction is also common). That not only is unfair, it is at odds with the revenue definitions governing other statutory licensees,<sup>22</sup> not to mention in Pandora’s agreements with ASCAP and BMI. SoundExchange’s witnesses have provided no explanation or justification for parting with standard industry practice or the prior regulations on this point.

c) **Data:** SoundExchange’s proposed revenue definition includes “Revenue generated by the use of exploitation of data gathered or generated from the Service.” The regulations governing satellite radio, by comparison, include only advertising and subscription

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unrelated revenue. First and foremost, a Service might offer other optional products or services – ticket sales, for example – in some arrangement less formal than a “Bundle” (which, under SoundExchange’s definition, requires a situation where the user *must* take/use/receive *both* the Service *and* other product/service). Second, SoundExchange provides no guidance to determine whether a Bundled service is or is not “involved” with the licensed Service.

<sup>22</sup> See, e.g., 37 C.F.R. § 382.11 (“gross revenues” definition) at (1)(ii) (excluding “advertising agency and sales commissions”); § 382.2(e)(2) (excluding “advertising agency commissions not to exceed 15% of those fees incurred to a recognized advertising agency not owned or controlled by Licensee”); § 383.2(g)(1)(ii) (same).

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revenue. See 37 C.F.R. § 382.11. Those regulations also exclude revenue for “current and future data services offered for a separate charge.” 37 C.F.R. § 382.11 at (3)(vi)(A).

d) **Bad Debt**: SoundExchange’s proposed revenue definition does not allow licensees to reduce the revenue base on account of bad debt. Bad debt expense reflects revenue that was initially booked as earned but that was not ultimately collected from the customer. SoundExchange is therefore proposing, again, that it and its members should get a cut of revenue that is never actually collected. The revenue definitions governing satellite radio and preexisting services exclude “bad debt expense” (§ 382.11 at (3(v)) and “bad debts actually written off during the reporting period” (§ 382.2 at (2)), as does the definition that applies to New Subscription Services (37 C.F.R. § 383.2 at (g)(viii) (requiring inclusion only of bad debts “recovered”)).

e) **Other Fees**: SoundExchange’s proposed revenue definition leaves out another exclusion found in the satellite radio revenue definition: the exclusion for “Sales and use taxes, shipping and handling, credit card, invoice, and fulfillment service fees.” Instead, it includes a deduction solely for sales, excise, and use taxes. The other items, however, no different than taxes, reflect fees that licensed services collect, not for the music service itself, but to cover costs charge by third parties for delivering the service – most of which are simply passed through to such third-parties (such as the local taxing authorities). In the case of credit card fees, while Pandora recognizes revenue for subscriptions paid by credit card, the credit card companies deduct their fees off the top prior to passing the revenue to Pandora. As a result, the revenue actually collected by Pandora is less (by the amount of the fees) than what is initially recognized. Absent such a deduction, Pandora would be paying royalties on revenues it does not actually collect.

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57. SoundExchange and its members have no entitlement to streams of revenue that are paid for items other than statutory streaming or (as to bad debt and credit card fees) are never collected in the first place. There is no reason SoundExchange should receive a share of the Company's revenues earned for lines of business, service offerings, data sales, or software and equipment sales that are not covered by the statutory license merely because Pandora is required to pay a royalty for performances that *are* covered by its statutory license. This could include the launch of an interactive streaming service (which would be separately licensed from sound recording copyright owners) or a business establishment service (where there is an exemption for the public performance of sound recordings). And there is even less reason for Pandora to be taxed on revenue that is never collected.

58. For just these reasons, such unrelated revenues are, as noted above, *excluded* from the definition of "Gross Revenues" for satellite radio and other categories of licensees. These exclusions grew from the Judges' recognition in the *Satellite I* proceeding that "[i]n order to properly implement a revenue-based metric, a definition of revenue that properly relates the fee to the value of the rights being provided is required."<sup>23</sup> The Judges accordingly defined "Gross Revenue" through a variety of exclusions in order to "more clearly delineate the revenues related to the value of the sound recording performance rights at issue."<sup>24</sup> Notably, when SoundExchange attempted to eliminate those exclusions in the *Satellite II* proceeding, the Judges rejected that attempt, explaining that they were "driven by the admonition in SDARS-I to include only those revenues related to the value of the sound recording performance rights at issue in this proceeding. The Judges are satisfied that the exclusions permitted in the current

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<sup>23</sup> See *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, Docket No. 2006-1 CRB DSTR ("Satellite I"), Fed. Reg. Vol. 73, No. 16 p. 4087 (Jan. 24, 2008).

<sup>24</sup> *Id.*

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Gross Revenues definition remain proper.” 78 Fed. Reg. 23054, at 23072 (citing SDARS–I, 73 FR at 4087) (internal citations omitted).<sup>25</sup> SoundExchange’s witnesses do not explain why the situation should be different here.

59. In sum, in order to ensure that SoundExchange is only paid on the portion of revenues derived by a licensee from operations under the statutory license, the regulations must account for the possibility that a service such as Pandora may be involved in multiple lines of business that fall outside of the scope of this proceeding, and may earn revenues from the operation of such services that are entirely distinct from the operations for which the Judges are currently establishing a royalty rate. The regulations should make clear that revenues of the licensee that are derived from any other service operated by the licensee are not to be included in the revenue base on which royalties are payable to SoundExchange.

60. Pandora’s definition of revenue does just that: it includes all money earned according to GAAP<sup>26</sup> derived from making eligible transmissions in the United States, and excludes revenue from activities other than making eligible transmissions or from eligible transmissions outside the United States.

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<sup>25</sup> The Judges continued: “In defining *Gross Revenues*, the Judges plainly stated that it was their intention to unambiguously relate the fee charged for a service provided by an SDARS to the value of the sound recording performance rights covered by the statutory licenses.” *Satellite II*, 78 Fed. Reg. at 23072 (citing SDARS–I, 73 FR at 4087).

<sup>26</sup> SoundExchange’s proposal, in addition to the problems noted above, defines revenue to include “all amounts paid, payable, credited, or creditable to Licensee, received or receivable by or on behalf of Licensee, or recognized by Licensee as revenue under United States Generally Accepted Accounting Principles (U.S. GAAP).” That proposal is redundant at best and confusing at worst: it is not at all clear, for example, how revenue that is “credited” or “creditable” is different than revenue that is “payable.” It also creates the possibility for audit disputes, *i.e.*, that SoundExchange or its auditors might identify revenues never recognized or received by Pandora as nonetheless being somehow “creditable” or “payable.”

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### B. Ephemeral Recordings Definition

61. SoundExchange has proposed to retain the language in Section 380.3 of the current regulations, which states:

*Ephemeral recordings.* The royalty payable under 17 U.S.C. 112(e) for the making of all Ephemeral Recordings used by the Licensee solely to facilitate transmissions **for which it pays royalties** shall be included within, and constitute 5% of, the total royalties payable under 17 U.S.C. 112(e) and 114.

62. Pandora has two concerns with SoundExchange's proposal. First, as indicated by the bolded language above, it appears to permit the making of ephemeral recordings only for sound recordings for which a performance royalty is paid. However, the definition of "Performance" proposed by SoundExchange (which mirrors the current definition and Pandora's proposed definition) exempts certain performances from payment, for example, "incidental" performances including "transitions in and out of commercials." See 37 C.F.R. § 380.2. This creates the possibility (likely unintended) that ephemeral copies of sound recordings that are used by a service for non-compensable performances under Section 114 might not be authorized under the regulations. To remedy this issue, Pandora has proposed the following simple change to Section 380.3:

*Ephemeral recordings.* The royalty payable under 17 U.S.C. 112(e) for the making of all Ephemeral Recordings used by the Licensee solely to facilitate transmissions ~~for which it pays royalties~~ **made pursuant to 17 U.S.C. 114** shall be included within, and constitute 5% of, the total royalties payable under 17 U.S.C. 112(e) and 114.

This edit clarifies that a webcaster is licensed to make ephemeral copies of sound recordings the performances of which are either payable *or* exempted from payment under Section 114.

63. In addition, the regulations adopted by the Judges should affirmatively state that statutory licensees are permitted to make as many ephemeral phonorecords of sound recordings as the licensee needs to optimize their statutory service. Clarification of this point – which I

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don't understand SoundExchange to be contesting – is important because the statute provides that a statutory licensee is entitled “to make no more than 1 phonorecord of the sound recording (*unless the terms and conditions of the statutory license allow for more*).” 17 U.S.C. § 112(e)(1) (emphasis added). The terms of the statutory license *should* call for “more,” for the obvious reason that statutory internet radio streaming necessarily involves making multiple copies to facilitate transmissions in different streaming formats and at different bit rates, to have backup copies available for disaster recovery purposes, and to handle the volume of a popular national streaming service, among other reasons. To eliminate any doubt, we recommend adding the following sentence to Section 380.3: “A Licensee is authorized to make more than one Ephemeral Recording of a sound recording as it deems necessary to make noninteractive digital audio transmissions pursuant to 17 U.S.C. 114.”

### C. Accelerated Timing of Royalty Payments

#### 1. 30-Day Payment Window

64. SoundExchange has proposed amending Section 380.4(c) of the regulations so that the timing of royalty payments be shortened from 45 to 30 days in order to expedite the royalty distribution process for artists and copyright owners. SoundExchange also calls for corresponding changes in the delivery deadlines for statements of account and reports of use. These changes should be rejected for several reasons, both procedural and substantive.

65. First, as the Judges know, there is a separate rulemaking proceeding addressing notice and recordkeeping regulations. In that proceeding, SoundExchange has already sought to shorten the period for delivery of reports of use from 45 to 30 days. Pandora and a number of other statutory licensees have opposed that recommendation and filed detailed comments explaining their opposition. There is no reason to rule on that topic here as well when it has been fully litigated elsewhere – or to give SoundExchange a second avenue for pursuing its desired



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result. Moreover, if the Judges reject SoundExchange's proposal in that separate proceeding to shrink the timing for submitting reports of use (thus maintaining the current 45-day window), it would make little sense to rule here that statements of account and payments should be submitted in a shorter 30-day window. As should be obvious, the statements of account and payment calculations are premised on the performances contained in the reports of use; if the reports are still being completed and vetted when the payment comes due (under the shorter 30-day window), it raises the possibility that the statements of account and payments could suffer from inaccuracies or – more likely – licensees would essentially be forced to complete their reports of use in 30 days to avoid such inaccuracies even though the deadline would be 45 days.

66. As Pandora explained in the separate recordkeeping rulemaking, there are also solid substantive reasons not to reduce the time period for delivering reports of use from 45 to 30 days – reasons that apply equally to monthly payments and statements of account (as SoundExchange proposes here):

SoundExchange proposes that licensees be required to deliver ROUs in 30 rather than 45 days. . . . The alleged reason for accelerating payment is to enable expedited payments to copyright owners and artists. . . .

There is simply no basis for accelerating the delivery of ROUs under the existing regulations. As SoundExchange appears to acknowledge, it is already able to distribute the overwhelming majority of royalties paid to it, and there appears to be little demand for accelerating payments by 15 days. Moreover, it strains credulity that reporting to SoundExchange could be improved by giving statutory licensees *less time* to complete ROUs. If SoundExchange is truly receiving ROUs that are incomplete or untimely, then perhaps the extant regulations are already too burdensome or the time period for reporting is too short. There is no evidence that accelerating reporting obligations will improve the quality of reporting, which is SoundExchange's stated goal.

. . .

The preparation of ROUs can be challenging. As described above, Pandora currently plays over 1.5 million unique sound recordings. This means that for any given month, Pandora generates an ROU with no fewer than 1.5 million rows of data. To compile those over 1.5 million rows of data, Pandora must determine the

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play counts for each one of those 1.5 million songs from billions of server instances (i.e., each time a user received a transmission of a sound recording). It takes significant resources to generate those reports and track performances at the volume at which Pandora operates.

...

Although Pandora can and does comply with today's reporting requirements within 45 days, accelerating ROU delivery while at the same time increasing the information to be included within ROUs while being subject to financial penalties for failing to do so accurately, will impose a significant and unreasonable burden on Pandora (and likely many other statutory licensees).

*See* Reply Comments of Pandora Media, Inc. in Recordkeeping Rulemaking at 15-17 (Sept. 5, 2014) (attached here as Pandora Exhibit 16).

67. The significant burden imposed upon licensees by shortening the payment and reporting deadlines from 45 to 30 days will not improve the quality of royalty calculations or reporting. Rather, accelerated payment and reporting will likely only lead to more hardships on licensees and greater likelihood of errors in payment calculation and reporting. That is simply not justified. The regulations should not impose significant additional burdens upon licensees for a marginal (if any) speedup in SoundExchange royalty allocation and distribution — especially if it introduces the possibility of errors in such distributions. SoundExchange recently touted that it distributed \$773 million in royalties in 2014, an increase of 31% over 2013 distributions. This was accomplished with payment and reporting deadlines of 45 days. The system is not broken and no fix is required.<sup>27</sup>

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<sup>27</sup> Marketplace agreements for the same rights at issue in this proceeding support retention of a 45-day payment period. *See* Agreement between Pandora Media Inc. ("Pandora") and Music and Entertainment Rights Licensing Independent Network B.V. ("Merlin"), § 12.a.

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### D. Verification of Royalty Payments.

#### I. Definition of “Qualified Auditor”

68. SoundExchange attempts to expand the universe of entities that can conduct a verification of a statutory webcaster by proposing elimination of the current requirement that a “Qualified Auditor” be a certified public accountant. Instead, SoundExchange seeks to allow any “person, who by virtue of education or experience, is appropriately qualified to perform an audit to verify royalty payments related to performances of sound recordings.” The Judges should reject this proposal for the same reasons they rejected a similar effort in *Webcaster II*.

69. Importantly, it is unclear what “by virtue of education or experience” means. What “education” or “experience” – apart from the rigorous accreditation and standards applied to CPAs – is appropriate for conducting an audit of a statutory licensee? Must the education or experience be in copyright law, network design or engineering, finance, accounting, or something else? Is one survey course in accounting sufficient? SoundExchange does not answer these questions.

70. But the Judges in *Webcaster II* did. There they noted that the purpose of verifications is not to provide them at the lowest price but to establish a high degree of credibility in the results of the verification. That credibility is achieved by requiring verifications solely by those who are governed by accepted standards and practices of auditing and standards of conduct:

By eliminating the requirements that an auditor be a CPA and independent from SoundExchange, SoundExchange is seeking to transform the prior verification process into what it calls “technical audits.” Technical audits would, in SoundExchange’s view, reduce its costs by allowing in-house technical experts to conduct the audits rather than outside CPAs, who might lack the technical capability for the data processing and analysis and may be more expensive than in-house personnel. The Copyright Royalty Judges have reviewed the record company/ music service agreements submitted by the parties and note that some agreements permit technical audits. Others, however, require the auditors to be

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CPAs, and that the auditor be independent of both the licensor and licensee. While technical audits by in-house personnel might be cheaper for the Collective, we conclude that it is more important, in the interest of establishing a high level of credibility in the results of the audit, that the auditor be independent of both parties. Likewise, we find that requiring the auditor to be certified further raises confidence levels in the audit. CPAs have experience in the field of accounting, are familiar with the accepted standards and practices for auditing, and are governed by standards of conduct. If technical skills are required to process the data of a Service, the auditor can request assistance. In sum, the Copyright Royalty Judges are requiring that the auditor be certified and independent of both SoundExchange and the Service being audited.

Final Rule and Order in Digital Performance Right in Sound Recordings and Ephemeral

Recordings, Docket No. 2005-1 CRB DTRA, 72 Fed. Reg. 24084, 24109 (May 1, 2007) (internal citations omitted).

71. This statement remains true today. I note that American Institute of Certified Public Accounts, Inc. (“AICPA”) recently revised its Code of Professional Conduct (effective December 15, 2014) (the “Code”), to clarify the rules that apply to all “members,” which includes a “member” in public practice, in business, and even to those who are retired or unemployed. *See* Code Section 0.100.02. These rules are designed to ensure the objectivity and integrity of members of the accounting profession. *See* Code Sections 0.300.030.02 and .04. The Code states that “[i]ntegrity is measured in terms of what is right and just” (Section 0.300.040.04) and prohibits the “subordination of the [auditor’s] judgment” to the interests of its client – here, SoundExchange. Code Section 0.300.050.03.

72. I have significant concerns about permitting an audit by a non-Qualified Auditor, as that term is currently defined in 37 C.F.R. § 380.2, that is not bound by these obligations. Specifically, I am troubled by the prospect of an auditor not governed by the Code conducting an audit solely to determine whether a licensee has *underpaid* royalties to SoundExchange rather than determining the *accuracy of payments* – whether underpayments or overpayments – under the statutory license. Following discussions with a representative of a music service that has

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been audited by one of SoundExchange's preferred auditors, I understand that the auditor (not a CPA, and therefore not a Qualified Auditor) has conducted regular audits solely to determine underpayments to a licensor. This approach could be particularly problematic where licensees undertake direct licensing efforts alongside reliance upon the statutory license to secure rights to sound recordings, as Pandora has done. If SoundExchange's auditor were not bound by standards of conduct, the auditor could search solely for evidence that a licensee had mistakenly claimed direct-license credit for a track not actually covered by the direct license (and thus underpaid SoundExchange), but not attempt to determine whether the licensee had overlooked performances where it could have claimed a direct-license credit (and thus overpaid SoundExchange).

73. Restricting audits to Certified Public Accountants will help avoid this result and ensure that the integrity of the audits is not brought into question by the auditor only looking for underpayments. To further ensure the independence of an auditor, the auditor should be prohibited from conducting audits on a contingency fee basis. Qualified Auditors should either be compensated on a flat fee or time and materials basis, but excluding any time spent consulting with SoundExchange, which should not be at the expense of the licensee. Finally, the regulations should be amended so that an auditor must determine whether an underpayment *or overpayment* has been made to the collective. Statutory licensees should not be penalized if they inadvertently overpay royalties to SoundExchange.<sup>28</sup> In the event of any such overpayment, the regulations should provide for a credit or refund to the licensee, with interest. As interest is

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<sup>28</sup> Pandora's proposed rates and terms amend § 380.6(c) to add the following: "Subject to Section 380.6(e), a Qualified Auditor must determine the accuracy of royalty payments made to the collective, including whether an underpayment or overpayment of royalties has been made, and the Qualified Auditor may not be compensated on a contingency fee basis."

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currently chargeable for any underpayment of royalties, interest should also be credited for any overpayment of royalties.<sup>29</sup>

### 2. *Acceptable Verification Procedure*

74. SoundExchange has also proposed the deletion of Section 380.6(e), which provides that an audit of a licensee already performed in the ordinary course of business shall “serve as an acceptable verification procedure.” This provision has been included in all of the regulations adopted for Webcasting since *Webcasting I*. It ensures that a licensee that is already subject to an audit by a Qualified Auditor in the normal course of business will not have to be burdened with a second audit by SoundExchange. I understand that it was negotiated by representatives of the recording industry and licensees in 2002, and there is no reason for that provision to now be excised from the regulations.

75. Where a statutory licensee is audited by a Qualified Auditor and the Qualified Auditor has concluded that the licensee’s financial statements present fairly, in all material respects, the consolidated results of the licensee’s operations and cash flows in conformity with U.S. generally accepted accounting principles (GAAP), that audit should suffice and preclude any further audits under CRB regulations. Pandora’s auditors would not be able to reach that conclusion and certify Pandora’s financial statements if Pandora was not accurately calculating its liabilities to SoundExchange, particularly where Pandora’s payments to SoundExchange are Pandora’s single largest expense.

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<sup>29</sup> Pandora’s First Amended Proposed Rates and Terms adds the following Section 380.6(h): “Make-up payments or credits. Upon the conclusion of the verification and the resolution of all claims between the Collective and the Licensee, (i) the Licensee shall, in the case of any underpayment, remit the amount of any agreed-upon underpayment to the Collective, as mutually agreed by the Collective and the Licensee, which agreement may, but need not, include installment payments, with interest, at the rate specified in Section 380.4(e) and (ii) the Collective shall, in the case of any overpayment, credit the account of the Licensee in the amount of any agreed upon overpayment to the Collective, with interest, at the rate specified in Section 380.4(e).”

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76. If the Judges accept SoundExchange's proposal on the theory that a routine financial audit may not devote sufficient attention to server log records and other more technical aspects of a licensee's royalty reporting mechanisms, then the Judges should at least retain the right of a licensee to have a Qualified Auditor conduct a verification of server logs in the ordinary course of business to serve as an acceptable form of verification. SoundExchange is currently in the position to wield an audit as a weapon, and licensees should not be subject to such harassment by either SoundExchange or the record companies that control it.

### E. Unclaimed Funds

77. SoundExchange has proposed in its Proposed Rates and Terms to push forward the current regulation for the treatment of so-called "unclaimed funds." Current regulations provide that in the event a sound recording copyright owner or featured artist entitled to a portion of a pool of royalties (presumably the royalties for a calendar month) fails to register with the collective within three years of the date of first distribution of all or any portion of that pool of royalties by SoundExchange, SoundExchange may retain those unclaimed funds [REDACTED]

[REDACTED]

78. [REDACTED]

[REDACTED]

Pandora therefore proposes the following amendment to

380.8:

If the Collective is unable to identify or locate a Copyright Owner or Performer who is entitled to receive a royalty distribution under this subpart, the Collective shall retain the required payment in a segregated trust account for a period of 3 years from the date of distribution. No claim to such distribution shall be valid after the expiration of the 3-year period. After expiration of this period, the Collective *shall handle such funds in accordance with* ~~may apply the unclaimed funds to offset any costs deductible under 17 U.S.C. 114(g)(3). The foregoing shall apply notwithstanding the common or State law or statutes of any State.~~

**PUBLIC VERSION**

Before the  
UNITED STATES COPYRIGHT ROYALTY JUDGES  
THE LIBRARY OF CONGRESS  
Washington, D.C.

In re

**DETERMINATION OF ROYALTY  
RATES AND TERMS FOR  
EPHEMERAL RECORDING AND  
DIGITAL PERFORMANCE OF  
SOUND RECORDINGS (WEB IV)**

Docket No. 14-CRB-0001-WR (2016-2020)

## DECLARATION OF MICHAEL HERRING

I, Michael Herring, declare under penalty of perjury that the statements contained in my Written Rebuttal Testimony in the above-captioned proceeding are true and correct to the best of my knowledge, information, and belief. Executed this 20<sup>th</sup> day of February, 2015 in Oakland, California.

Michael Herring